No. 10246

In the United States Circuit Court of Appeals for the Ninth Circuit

SAN JOAQUIN VALLEY POULTRY PRODUCERS ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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CITATIONS

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OPINION BELOW

The memorandum opinion of the Board of Tax Appeals (R. 19–32) is unreported.

JURISDICTION

This petition for review (R. 33–40) involves federal income taxes for the calendar years 1936 and 1937 (R. 3–4, 10–11). On April 8, 1940, the Commissioner of Internal Revenue mailed to the taxpayer notice of deficiency in the total amount of $4,308.49. (R. 10–17.) Within 90 days thereafter and on June 17, 1940, the taxpayer filed with the Board of Tax Appeals a petition for redetermination of deficiency (R. 3–17) under the provisions of Section 272 of the Internal Revenue Code. The decision of the Board of Tax Appeals sustaining

the deficiency was entered on June 19, 1942. (R. 33.) The case is brought to this Court by a petition for review filed August 13, 1942 (R. 40), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether the taxpayer, a cooperative association organized under the Agricultural Code of California, is entitled to deduct from gross income for the taxable years amounts retained by it and credited to certain reserve funds, where allocable portions of the amounts so retained were credited to the accounts of its members on a patronage basis.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in the Appendix, *infra*, pp. 27–31.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 20–28) may be summarized as follows:

The taxpayer is a cooperative association organized under the laws of California, with its principal place of business in Porterville, Tulare County. It filed its income tax returns for the years 1936 and 1937 with the Collector of Internal Revenue for the Northern District of California. (R. 20.)

The members of the taxpayer are poultry producers. Membership is acquired by the payment of a $10 fee, as provided in the by-laws, which, with the articles of incorporation, are in evidence and incorporated by

reference in the Board's findings. The taxpayer maintains at Porterville, California, a feed mill, warehouse, and an office. (R. 20.) Its business consists of (1) a "Marketing Division" for the marketing of poultry and eggs for producers, and (2) a "Purchasing Division" for the sale of feed and other farm supplies to poultry producers. (R. 21, 93–95, 101–102, 124–132, Pet. Ex. 1.) During the years 1936 and 1937, the taxpayer marketed its eggs in weekly pools and made payments to the members participating in the pools on the basis of the number of eggs marketed by the taxpayer for each member. The payments to members were determined by the quotations on the Los Angeles market less estimated expenses. The taxpayer also marketed eggs for nonmembers during the years 1936 and 1937, but the nonmembers did not participate in the pools. Eggs obtained from nonmembers were treated as cash purchases for resale. During the years 1936 and 1937, the taxpayer made sales of feed and other farm supplies to both members and nonmembers. (R. 21.) The prices at which such supplies were sold to members were based on direct cost to the taxpayer, plus overhead expenses, the prices fixed being slightly above such expenses so that there would be no danger of loss to the taxpayer. (R. 21, 146–148, Pet. Ex. 12.)

Article VIII of the taxpayer's bylaws provides, in Section 1, that "Net Proceeds" shall be such funds as the taxpayer derives from overcharges on purchases made by both members and nonmembers. These net proceeds of the "Purchasing Division", according to the bylaws, shall belong to the members and shall be

known as "Members' Purchase Credits." (R. 25.) Disposition of the members' purchase credits is provided for as follows (R. 125):

> The Directors, after providing for all necessary overhead and all duly authorized reserves, are authorized to prorate and refund all of the rest of the "Members' Purchase Credits" to the members in proportion to each member's purchases from the Association during the time such "Members' Purchase Credits" shall have accumulated, all in the manner particularly set forth as follows:
>
> Twenty-five (25) percent thereof to be prorated and paid to the member in cash annually as soon as practical after the close of business at the end of each fiscal year and after the Auditor shall have completed the annual audit and shall have released his report to the Directors; seventy-five (75) percent thereof to be applied to the creation and maintenance of a "Feed Finance Fund" all as provided for elsewhere in these By-Laws.

Section 2 provides for the creation of a "Feed Finance Fund" of $60,000 by retention of 75 percent of the members' purchase credits. It also provides for issuance to members of interest-bearing certificates, representing the amounts retained, and for retirement of such certificates in the order of issuance when that may be done without reducing the fund below $60,000. (R. 126.)

An egg marketing pool for members is authorized by Section 3. The section further provides that the taxpayer may, in addition to the cost of marketing, with-

hold one cent from the proceeds of each dozen eggs marketed through the pool for the purpose of establishing an "Advance Fund." These deductions from proceeds of the taxpayer's marketing division are designated "Members' Egg Pool Credits", and the taxpayer, according to this section of the by-laws, is authorized to issue interest-bearing "Advance Fund Certificates" representing such deductions. Section 4 provides for creation of an advance fund, to be maintained at a level of $60,000, and for retirement of the certificates in the order issued. (R. 126–128.)

The taxpayer is authorized by Section 9 (R. 130–131) to use any moneys in the feed finance fund and the advance fund for purchase of land, buildings, equipment, etc., or as working capital in the operation of the business.

Section 7 of Article VIII of the by-laws sets up a "Membership Fund" consisting of all membership fees paid to the taxpayer. This fund may also be invested in land, buildings, equipment, or used as working capital. (R. 129–130.) A reserve for security of the membership fund is established by Section 8, which provides as follows (R. 130):

> Section 8. There shall be reserved out of the earnings of the business of the Association each year ten (10) per cent of the net earnings for a Reserve Fund for security of the Membership Fund; such amount shall be computed annually, deducted after all other deductions for interest, overhead and operating expenses have been made and before "Members' Purchase Credits" have been prorated.

> Any moneys in this Reserve Fund or in any other Fund may be invested in property belonging to the Association, in outside securities, or used as a working capital in the operation of the business, * * *.

Section 10 of the same article authorizes the taxpayer to do business with nonmembers as well as members, and permits it to buy poultry and other agricultural produce from producers for cash if the board of directors deems it advisable. (R. 131.)

On December 21, 1936, the taxpayer's board of directors adopted the following several resolutions:

(1) A resolution authorizing the payment of patronage dividends to members and nonmembers alike, for the year 1936, in cash or its equivalent (R. 21);

(2) A resolution of the taxpayer's marketing division authorizing the creation of an account on the books of the taxpayer, designated "Reserve Against Loss by Overpayment", and reciting that the aggregate amount retained from proceeds of the sale of eggs marketed by the taxpayer for members during the year 1936 amounted to $1,683.56, and that this amount was to be credited to a reserve for overpayments in order to avoid loss from market fluctuations, deterioration, carrying charges, or unexpected expenses in the marketing of eggs by the taxpayer (R.21);

(3) A resolution of the purchasing division authorizing that the sum of $5,722.72 be transferred on the books of the taxpayer to an account entitled "Reserve for Zoning Hazard" (R. 21);

(4) A resolution of the purchasing division authorizing the transfer of $2,215.29 to an account on the

books of the taxpayer entitled "Reserve for Security of Membership," this amount being 10 percent of the taxpayer's net earnings as shown by its books for the year 1936 (R. 22);

(5) Finally, a resolution of the purchasing division declaring a patronage dividend in the amount of $14,214.93, consisting of $11,725.75 to members and $2,489.18 to nonmembers, to be paid in cash or its equivalent. The resolution stated that this amount represented a dividend to members of two percent on all purchases in addition to authorized reserves credited to members, and a larger dividend to nonmembers, "equalling in percentage the amount carried to reserves for accounts of members" (R. 22).

At a meeting held on December 31, 1937, the board of directors of the taxpayer adopted the following several resolutions:

(1) A resolution relating to both purchasing and marketing divisions, reciting that it was the intention of the taxpayer that its members should be credited on the books with their pro rata share of any amounts retained by the association which did not represent valuation reserves or other costs and expenses of the taxpayer, and that such credits should be paid to its members whenever its board of directors should determine that the taxpayer had available funds therefor, not needed for its use. The resolution authorized the accountants of the taxpayer to determine the amounts allocable as credits to the members, and to record such credits on the books of the taxpayer, and recited that

the taxpayer recognized the obligation to repay such credits in the manner stated (R. 22–23);

(2) A resolution of the purchasing division of the taxpayer's business authorizing transfer of $9,657.81 on the books of the taxpayer to an account designated "Reserve for Zoning Hazard" (R. 23);

(3) A resolution of the purchasing division authorizing transfer of $2,601.90 on the books of the taxpayer to the account "Reserve for Security of Membership," this amount being 10 percent of the net earnings of the taxpayer, as disclosed by its books for the year 1937 (R. 23);

(4) Finally, a resolution of the purchasing division declaring a patronage dividend in the amount of $18,058.65, consisting of a dividend to members in the amount of $17,924.32 and a dividend to nonmembers in the amount of $134.33, to be paid in cash or its equivalent before closing its books for the year 1937. This dividend, like that in the previous year, was declared on a percentage basis to members and a larger percentage to nonmembers (R. 23).

The account designated "Reserve for Zoning Hazard" was set up to provide against the possibility of a change in the zoning ordinance of the City of Porterville. The plant of the taxpayer was in a residential region. Since there was a zoning ordinance authorizing the taxpayer to operate its plant, and the adjoining landowners asserted that its noise, dust, and dirt created a nuisance, against which they threatened legal action, the taxpayer felt that zoning restrictions might be enacted requiring removal of its plant to another site.

(R. 23.) The reserve for security of membership, authorized in the bylaws, is maintained for the purpose of protecting the taxpayer against any loss in its working capital. The reserve against loss by overpayment was established to protect the taxpayer against any payments of excessive amounts to members marketing their eggs in pools. The returns from the marketing of eggs were uncertain. When the taxpayer paid its members for eggs still unmarketed and at prices then quoted on the market, it ran the risk that it would not realize as much when the eggs were sold by it. Uncertainty in estimating expenses was also involved. This reserve was intended to protect the taxpayer against both these risks. When any of the amounts were transferred to the reserves described above, the taxpayer's books showed the credits to such reserves but there was no physical segregation of cash or funds representing the amounts of these reserves. All of the moneys of taxpayer were kept in one fund. (R. 26–27.)

The account of each member of the taxpayer was credited with a proportionate share of each of the three reserve funds and a statement of membership equity was sent annually to each member. (R. 27, 148–150, Pet. Ex. 13–14.) However, none of the amounts so credited could be withdrawn from these reserves by the members. (R. 27.) Authorization by the taxpayer's board of directors was necessary to make any portion of the reserves available to members. The policy of the board of directors was to authorize payment to members whenever the financial condition of the taxpayer was such that the amounts credited to the various

reserve accounts could be paid to members without any detriment to the taxpayer. It was understood at all times that all the moneys represented by the reserves, which were in turn credited to the various accounts of the members, could be used by the taxpayer for any of the purposes authorized in its by-laws. But if these amounts were to be used by the taxpayer for payment to members in cash or interest-bearing certificates, the payment had to be authorized by the board of directors of taxpayer. (R. 26–27.)

Patronage dividends, when declared, ~~was~~ were credited to the accounts of the members. (R. 27.) The amounts so declared by the resolutions of 1936 and 1937 were paid without any additional authorization by the board of directors. (R. 24.) Payments to the extent of 25 per cent of the amounts due were made in cash; the remainder in interest-bearing certificates, as provided in the by-laws. (R. 25–26, 27.)

In making its income tax returns for 1936 and 1937, the taxpayer claimed as deductions from its gross income the sums covered by all the above-enumerated resolutions. (R. 19–20.) The Commissioner allowed deductions of the amounts declared and distributed by the taxpayer as patronage dividends, and also $4,299.35 of the $9,657.81 allocated to the 1937 reserve for zoning hazard. (R. 4, 125.) He disallowed all the remaining amounts placed in the three reserve funds. (R. 12–17.)

Upon these findings the Board concluded that the amounts retained by the taxpayer and allocated to "Reserve for Zoning Hazard", "Reserve for Security of Membership", and "Reserve Against Loss by Over-

payment'' remained in the control of the taxpayer, and that the mere crediting of the members' accounts with proportionate parts of the amounts so retained did not place those amounts at the disposal of the members. The Board, therefore, sustained the Commissioner's ruling disallowing deductions of the amounts held in reserve. (R. 28–32.)

SUMMARY OF ARGUMENT

The taxpayer, although a cooperative association, is not exempt from taxation under Section 101 (12) of the Revenue Act of 1936. Section 101 (12) exempts only those farmers' cooperative associations which return the proceeds of their marketing and purchasing operations to all patrons, whether members or nonmembers, on an equal basis. The taxpayer did not return marketing proceeds to nonmember patrons in 1936 and 1937, but instead purchased their produce for cash and resold it for its own account, in contrast to its method of doing business with members. The taxpayer concedes that it realized certain taxable net income from nonmembers. Even if the taxpayer had returned its proceeds equally to members and nonmember patrons, it is not exempt by Section 101 (12) because the reserve funds which it set up in 1936 and 1937 from proceeds are not shown to be reasonable reserves for necessary purposes as required by the statute.

The amounts of net proceeds retained by the taxpayer and placed in three reserve funds constitute income to the taxpayer. Neither the Agricultural Code of the

State of California nor the taxpayer's by-laws divest the taxpayer of ownership and control of its net proceeds. The right of members to receive any part of the proceeds is determinable solely by the taxpayer.

The amounts retained in reserve are not deductible from gross income as patronage dividends. There is no statutory provision allowing deduction of patronage dividends from the gross income of a cooperative association which is not exempt from taxation by Section 101 (12). By administrative practice, however, proceeds returned to patrons during the taxable year are deductible. The Board of Tax Appeals found that the amounts retained by the taxpayer in the reserves here in issue were not in fact returned to the members during those years. The record shows that the crediting of the account of each member with a *pro rata* share of each reserve did not constitute a return of the proceeds to the members. Payments were to be made to members from the reserves only "when, as, and if" the directors determined the taxpayer did not need the funds retained. Only by further action of the taxpayer's board of directors can the amounts so credited become available to the members. Until such further action the credits are not a fixed liability of the taxpayer to its members, for they can maintain no suit for recovery of the credits. Since the amounts of net proceeds retained in the reserves remained solely in the control of the taxpayer during 1936 and 1937, the taxpayer was not entitled to deduct those amounts from its gross income of those years.

ARGUMENT

The taxpayer is not entitled to deduct from the gross income of the taxable years amounts retained and credited to the reserve funds, even though allocable portions of the amounts so retained were credited to the accounts of its members on a patronage basis

a. The taxpayer is not tax-exempt under Section 101 (12) of the Revenue Act of 1936, since it realizes profit from its business with nonmembers

The taxpayer, although a cooperative association, is not entitled to exemption from taxation under the provisions of Section 101 (12) of the Revenue Act of 1936 (Appendix, *infra*). Section 101 (12) exempts only (1) those farmers' cooperative marketing associations which turn back to the producers the proceeds of the sales, less the necessary marketing expenses, on the basis of the products furnished by them, and (2) those farmers' cooperative purchasing associations which turn over supplies to purchasers at actual cost plus necessary operating expenses. By way of interpretation of this section, Article 101 (12)–1 of Treasury Regulations 94 (Appendix, *infra*) provides:

> * * * nonmember patrons must be treated the same as members in so far as the distribution of patronage dividends is concerned, that is, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association.
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> * * * * *
>
> An association engaged both in marketing farm products and in purchasing supplies and equip-

ment is exempt if as to each of its functions it meets the requirements of the Act.

Thus, a cooperative association which fails to accord equal treatment to all its patrons, whether members or nonmembers, with regard to the distribution of proceeds realized from both marketing and purchasing operations is not entitled to the statutory exemption. *Farmers Union Co-op. Co.* v. *Commissioner,* 90 F. 2d 488 (C. C. A. 8th); *Fruit Growers' Supply Co.* v. *Commissioner,* 56 F. 2d 90 (C. C. A. 9th); *South Carolina Produce Ass'n* v. *Commissioner,* 50 F. 2d 742 (C. C. A. 4th); *Producers' Creamery Co.* v. *United States,* 55 F. 2d 104 (C. C. A. 5th); *Fertile Co-operative Dairy Ass'n* v. *Huston,* 119 F. 2d 274 (C. C. A. 8th); *Farmers Co-operative Co.* v. *United States,* 23 F. Supp. 123 (C. Cls.); *Farmers Union Co-operative S. Co.* v. *United States,* 23 F. Supp. 128 (C. Cls.), motion for new trial denied, 25 F. Supp. 93.

The taxpayer did not satisfy the statutory requirements in 1936 and 1937, the taxable years involved. Through its marketing division during those years, the taxpayer marketed eggs for its members in weekly pools and returned to them the proceeds less estimated expenses. It also sold eggs obtained from nonmembers. The nonmembers, however, did not participate in the marketing pools. Instead, the taxpayer made outright purchases of their eggs for cash and resold them for its own account. (R. 52–53.) In the purchasing division feed and supplies were sold to members on the basis of cost plus estimated expense of handling. (R. 54.) Sales were also made to nonmem-

bers. (R. 53–54.) The taxpayer itself, in its petition to the Board for redetermination of deficiency (R. 3–9), concedes that it realized certain net income from its dealings with nonmembers in 1936 and 1937 which was taxable net income (R. 7–9). Although patronage dividends from its proceeds were distributed to both members and nonmembers in 1936 and 1937, the resolutions of the board of directors disclose that such dividends were declared only with respect to the taxpayer's sales of feed and supplies, which were handled through its purchasing division. (R. 137–138, 143–145, Pet. Ex. 5, 10.) Nonmembers did not receive any *pro rata* return of proceeds from operations of the marketing division of the taxpayer. (R. 8, 52–53, 136, Pet. Ex. 4.) For this reason alone the taxpayer is not entitled to the statutory exemption. *Farmers Union Co-op. Co.* v. *Commissioner, supra; Fruit Growers' Supply Co.* v. *Commissioner, supra; South Carolina Produce Ass'n* v. *Commissioner, supra.* The fact that the percentage of business with nonmembers was relatively small is without significance. *Fruit Growers' Supply Co.* v. *Commissioner, supra,* p. 92. Nor does the fact that the taxpayer may have been operating in accord with the California statutes under which it was incorporated give it an exempt status under Section 101 (12), for the exemption depends solely on the terms of the federal statute and compliance or noncompliance with state statutes is irrelevant. *Farmers Union Co-op. Co.* v. *Commissioner, supra,* p. 492; *Farmers Co-operative Co.* v. *United States, supra.*

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b. There is no evidence that the reserve funds for which deductions have been disallowed are reasonable reserves for necessary purposes within the meaning of Section 101 (12)

Even if the taxpayer here had treated its member and nonmember patrons equally with regard to the distribution of the proceeds of both its marketing and purchasing operations, it would not qualify as a corporation exempt from taxation under Section 101 (12). To gain exemption under Section 101 (12), it is incumbent upon the association to establish that any reserve which it has set up is a reasonable reserve for a necessary purpose,[1] "such as to provide for the erection of buildings and facilities required in business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such purposes". Treasury Regulations 94, Article 101 (12)–1. See *Fertile Co-operative Dairy Ass'n* v. *Huston, supra,* p. 276. Cf. *Burr Creamery Corp.* v. *Commissioner,* 62 F. 2d 407 (C. C. A. 9th), certiorari denied, 289 U. S. 730; *Riverdale Co-op. Creamery Ass'n* v. *Commissioner,* 48 F. 2d 711 (C. C. A. 9th); *Uniform Printing & S. Co.* v. *Commissioner,* 33 F. 2d 445 (C. C. A. 7th), certiorari denied, 280 U. S. 591.

The taxpayer failed to establish that the three reserve funds for which the Commissioner disallowed

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[1] Section 101 (12) also provides that exemption shall not be denied an otherwise qualified cooperative association because it maintains reserves "required by State law." The taxpayer here makes no contention that the reserves in issue are required by the California statutes under which it is incorporated. Our examination of these statutes discloses no requirement that reserves be maintained. See Deering, Agricultural Code of the State of California (1937), Sections 1191–1221.

deductions were reasonable reserves for necessary purposes, and the Board of Tax Appeals so found. (R. 28–29.) The reserves here in issue are designated by the taxpayer as (1) "Reserve for Zoning Hazard", (2) "Reserve Against Loss by Overpayment for Eggs", and (3) "Reserve for Security of Membership Fund". They were set up from proceeds, otherwise distributable to members, to protect the taxpayer against possible future contingencies (R. 45, 62–63, 65, 68–69), and were in addition to the customary annual reserves for depreciation and bad debts (R. 137, Pet. Ex. 5; R. 139, Pet. Ex. 7; R. 142, Pet. Ex. 9; R. 143, Pet. Ex. 10). As the Board of Tax Appeals points out, the taxpayer introduced no substantial evidence as to the reasonableness of the amount set aside in the zoning hazard reserve. The testimony discloses only that removal of the taxpayer's plant from the residential area where it was located or remodeling of the plant "would probably cost considerable money." (R. 62.) It is important to note that the Commissioner allowed the taxpayer to deduct from its gross income in 1937 the sum of $4,299.35 on account of the zoning hazard. The taxpayer had set aside in 1937 a total of $9,657.81. (R. 145, Pet. Ex. 11.) The Commissioner disallowed only $5,358.46 of that amount. (R. 15.) In the absence of evidence that the Commissioner's ruling was erroneous, this administrative determination of the reasonable limit for such a reserve must be sustained by this Court. *Matern* v. *Commissioner,* 61 F. 2d 663 (C. C. A. 9th); *Lightsey* v. *Commissioner,* 63 F. 2d 254 (C. C. A. 4th).

The reserve against loss by overpayment for eggs was explained as a fund for protection of the taxpayer

against losses "at sometime in the future," because of miscalculation of marketing expenses or in the event of market fluctuations between the time the eggs were received from producers and the time they were marketed. (R. 69.) The extent of such losses in other years, if any, is not disclosed. The reserve for the security of membership fund, according to the testimony of the general manager, was "for the purpose of protection against loss and the supplying of capital working fund." (R. 68.) The record does not show the extent of the taxpayer's need of additional working capital. The by-laws of the taxpayer provide other sources of substantial working capital for the taxpayer's operations. (R. 124–128, 129–131, Pet. Ex. 1, By-laws, Art. 8, Secs. 1–4, 7, 9.) In 1936 and 1937, 75 percent of the current patronage dividends declared were paid in interest-bearing certificates, and the moneys represented by such certificates were thus made available to the taxpayer. (R. 137–138, Pet. Ex. 5; R. 143–145, Pet. Ex. 10.) In brief, the taxpayer offered no satisfactory proof either of the reasonableness of the amounts retained and allocated to these reserves or of the necessity for such reserves.[2] The burden is on the taxpayer to establish by substantial evidence that any reserve which it set up was reasonable and necessary in the situation. *Welch* v. *Helvering,* 290 U. S. 111; *Fertile Co-operative Dairy Ass'n* v. *Huston, supra; Matern* v. *Commissioner, supra.* Clearly, the taxpayer here, as the Board found (R. 28–29), did not sustain that burden.

[2] There is likewise no evidence that the taxpayer is entitled to deduct from gross income the amounts retained as reserves for ordinary and necessary business expenses.

c. The amounts of net profits retained in reserve constitute income to the taxpayer and not to its members

Since the taxpayer is not exempt from taxation by Section 101 (12), the Commissioner correctly included in the taxpayer's gross income the amounts of net proceeds retained by it and placed in reserve funds. The net proceeds from the operations of a nonexempt cooperative marketing and purchasing association constitute income to the association. *Farmers Union Co-op. Co.* v. *Commissioner, supra; Co-operative Oil Ass'n* v. *Commissioner,* 115 F. 2d 666 (C. C. A. 9th); *Fruit Growers' Supply Co.* v. *Commissioner, supra; Farmers Union Cooperative S. Co.* v. *United States,* 25 F. Supp. 93 (C. Cls.). An incorporated cooperative association, like any other corporation, is a distinct corporate entity, existing separate and apart from its members. As such, the proceeds of its business belong to it and not to its members. *Farmers Union Co-op. Co.* v. *Commissioner, supra; Callaway* v. *Farmers Union Cooperative Ass'n,* 119 Nebr. 1, 226 N. W. 802.

The Agricultural Code of the State of California (See Deering, Agricultural Code of the State of California (1937), Sections 1191–1221) does not divest the taxpayer here of the proceeds of its operations and thereby relieve it of an obligation to pay federal income taxes on its net earnings. The statute does not vest the proceeds either in patrons or members, but leaves such proceeds in the sole control of the taxpayer without even specific provision for their distribution. The taxpayer is empowered, under the statute, to exercise all ordinary corporate powers, including the right to own property and to establish reserves and invest funds.

Likewise, the taxpayer's by-laws do not divest the taxpayer of sole control of the proceeds of its business. Under the by-laws, they may be expended for the purchase of land, buildings, equipment and supplies, or used as working capital. (R. 124–131, Pet. Ex. 1.) It is true that the by-laws state that the "Net Proceeds" shall belong to the members, but this provision apparently refers only to the proceeds of the "Purchasing Division" of the taxpayer's business. (R. 124–125, Pet. Ex. 1.) Moreover, the rights of members to possess the proceeds is vested solely in the discretion of the directors. Paragraphs 18th and 19th of Section 11, Article IV (R. 115–116, Pet. Ex. 1), empower the board of directors to create and maintain reserve funds for any purpose and "after making such financial provisions * * * as they deem for the best interest of the Association, * * * *to refund to the members* * * * *the balance* of any overcharges from sales * * *." (Italics supplied.) Section 1 of Article VIII (R. 125, Pet. Ex. 1) authorizes the board of directors, "after providing for all necessary overhead and all duly authorized reserves," to prorate and *refund to the members the remainder of the net proceeds* resulting from the operations of the business. We submit that under the statute and by-laws there can be no other conclusion than that the proceeds of the business constitute income to the taxpayer. The taxpayer's contention to the contrary is fully disposed of by the Eighth Circuit Court of Appeals in *Farmers Union Co-op. Co.* v. *Commissioner, supra,* where that court considered a similar contention and concluded that the

proceeds of a cooperative association which transacted business with both members and nonmembers constituted taxable income to the association.

d. The amounts retained in reserve are not deductible from the taxpayer's gross income as patronage dividends, even though allocable portions of the amounts so retained were credited to the accounts of its members on a patronage basis, since such credits were not immediately available to the members

The taxpayer contends that, even if the reserves are not otherwise exempt from taxation, substantially all its net proceeds in 1936 and 1937, including the amounts retained in the reserve funds, were deductible from its gross income as so-called patronage dividends. This Court recognized in *Co-operative Oil Ass'n* v. *Commissioner, supra,* that there is no express statutory provision permitting the deduction of patronage dividends by cooperative associations which do not qualify as tax-exempt cooperatives under the appropriate revenue laws. The administrative practice, however, has been to permit cooperative associations, even though not entitled to a tax-exempt status, to deduct from gross income the amounts returned to their patrons, whether members or nonmembers, upon the basis of purchases or sales, or both, made by or for them. See I. T. 1499, I–2 Cum. Bull. 189 (1922); A. R. R. 6967, III–1 Cum. Bull. 287 (1924); *Trego County Cooperative Association* v. *Commissioner,* 6 B. T. A. 1275; *Home Builders Shipping Association* v. *Commissioner,* 8 B. T. A. 903; *Anamosa Farmers Creamery Co.* v. *Commissioner,* 13 B. T. A. 907; *Farmers' Union Co-operative Association* v. *Commissioner,* 13 B. T. A. 969; *Fruit Growers Supply Co.* v. *Commissioner,* 21 B. T. A. 315;

Midland Cooperative Wholesale v. *Commissioner,* 44 B. T. A. 824. Such deductions are solely a matter of administrative grace and are not permitted unless the amounts have in fact been returned to members or patrons of the association during the taxable year. *Co-operative Oil Ass'n* v. *Commissioner, supra; Farmers Union Co-op Co.* v. *Commissioner, supra; Farmers Union Co-operative S. Co.* v. *United States,* 25 F. Supp. 93 (C. Cls.); *Fruit Growers' Supply Co. v. Commissioner, supra.* Actual payment during the taxable year is not required, but the association must have taken whatever action is necessary to give its members an immediate right to possess the funds. See *Home Builders Shipping Association* v. *Commissioner, supra; Midland Cooperative Wholesale* v. *Commissioner, supra.* A return of proceeds to the patrons of a cooperative association ordinarily can be accomplished only by the actual declaration and distribution of a patronage dividend by its board of directors. Until such action, the proceeds belong to the association, which is a separate corporate entity, and the patrons have no greater interest in them than stockholders have in the undistributed earnings of an ordinary corporation. *Farmers Union Co-op Co.* v. *Commissioner, supra; Callaway* v. *Farmers Union Cooperative Ass'n, supra.* See also *Fruit Growers' Supply Co.* v. *Commissioner, supra; Co-operative Oil Ass'n* v. *Commissioner, supra; Burr Creamery Corp.* v. *Commissioner, supra.* Cf. *Penn Mutual Co.* v. *Lederer,* 252 U. S. 523.

The amounts here in issue, although constituting net proceeds of the taxpayer's business, were not declared and paid by the taxpayer as a part of the patronage

dividends returned to members in 1936 and 1937. (R. 137–138, Pet. Ex. 5; R. 143–145, Pet. Ex. 10.) In contrast to the patronage dividends of those years, which became available to members in cash or interest-bearing certificates as soon as declared by resolutions of the taxpayer's board of directors, these amounts were retained in reserves. The taxpayer argues, however, that the crediting of *pro rata* shares of the reserves to the account of each of its members constituted a distribution of the reserves and created a liability of the taxpayer to its members. As such, the taxpayer contends the Commissioner should have allowed the amounts so allocated during the taxable years to be deducted from gross income. The Board of Tax Appeals rejected this contention and concluded that further action by the taxpayer's board of directors was necessary before any portion of these reserves could become available to the members. (R. 31.) The evidence amply supports the Board's conclusion.

The resolution of the board of directors allocating to members the *pro rata* shares of the reserve funds states (R. 141):

> Such credits shall be paid * * * *when, as, and if the board of directors of the association determines that the association has available funds therefor* not to be needed for the use of the association; * * * [Italics supplied.]

Nor did the resolutions of the board of directors creating the three reserve funds authorize payments to members from these funds. (R. 136, Pet. Ex. 4; R. 138–139, Pet. Ex. 6–7; R. 142–143, Pet. Ex. 9; R. 145,

Pet. Ex. 11.) Testimony of the general manager establishes that only by further action of the board of directors could the amounts so credited become available to the members. (R. 66, 68, 70–71, 73.) If the contingencies should arise for which the reserves were established, the by-laws permitted, and it was the intention of the taxpayer to expend the amounts therein for the specified purposes. (R. 73.) Thus, the amounts in reserve could not be depleted by the members at any time, and were to become available to the members only when and if the board of directors so ordered. Moreover, the resolution above quoted establishes that the taxpayer was under no fixed liability to the members. Any payment from the reserves was conditioned on determination by the taxpayer's board of directors that the taxpayer did not need the funds for its own use. The existence and extent of the liability was, therefore, not fixed by action of the taxpayer in the taxable years involved, but was contingent upon future events. See *Commissioner* v. *Brooklyn R. S. Corp.*, 79 F. 2d 833 (C. C. A. 2d). This Court in *Co-operative Oil Ass'n* v. *Commissioner, supra,* held that a resolution providing for retention of net proceeds in a reserve for working capital and for payment to members from the reserve at some time in the future when a sufficient reserve had been accumulated did not constitute a distribution of patronage dividends within the taxable year. The additional fact in the present case that *pro rata* shares were credited to the accounts of each member does not constitute the distribution lacking in the *Co-operative Oil Ass'n* case. This is true because the credits were conditional and

until the board of directors of the taxpayer takes action releasing the credits to members there is no fixed right in the members on which they can maintain suit for recovery. *Callaway* v. *Farmers Union Cooperative Ass'n, supra.* Cases relied upon by the taxpayer (*Bogardus* v. *Santa Ana W. G. Assn.,* 41 Cal. App. 2d 939, 108 P. 2d 52; *Loomis F. G. Assn.* v. *California F. Exch.,* 128 Cal. App. 265, 16 P. 2d 1040) are not to the contrary. They indicate only that, after a cooperative association has declared a patronage dividend *and the date fixed for payment has passed,* a member may bring suit to recover the amount due.

Midland Cooperative Wholesale v. *Commissioner, supra,* relied upon by the taxpayer (Br. 29–32), is distinguishable. In that case the Board found that no additional corporate action was required to make immediately available to the members the amounts credited to them. In contrast, the Board has found here that further corporate action is necessary. Moreover, in that case deduction of amounts placed in a permanent surplus, similar to the reserve funds here, was disallowed.

We therefore submit that the amounts retained in reserve by the taxpayer did not constitute proceeds returned to the members within the taxable year and were, therefore, not deductible from gross income by virtue of the administrative practice permitting deduction of patronage dividends. What this Court said in *Co-operative Oil Ass'n* v. *Commissioner, supra,* p. 668, is fully applicable to the taxpayer's contention here:

> * * * petitioner points to no statute authorizing any deduction whatever, and we are in effect asked to hold that a practice of respondent permitting a deduction not authorized by statute, is not liberal enough. We know of no manner in which such liberality may be reviewed in this court. It is familiar law that "Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed" and "a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms". *New Colonial Ice Co.* v. *Helvering,* 292 U. S. 435, 440, 54 S. Ct. 788, 790, 78 L. Ed. 1348. See also: *White* v. *United States,* 305 U. S. 281, 292, 59 S. Ct. 179, 83 L. Ed. 172.

CONCLUSION

The decision of the Board is correct and it should be affirmed.

Respectfully submitted,

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DECEMBER, 1942.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this title—

* * * * *

(12) Farmers', fruit growers', or like associations organized and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (b) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses. Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 per centum per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association; nor shall exemption be denied any such association because there is accumulated and maintained by it a re-

serve required by State law or a reasonable reserve for any necessary purpose. Such an association may market the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, and may purchase supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 per centum of the value of all its purchases. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this paragaph;

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 101 (12)–1. *Farmers' cooperative marketing and purchasing associations.*—(a) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, live stock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses, on the basis of the products furnished by them, are exempt from income tax and shall not be required to file returns. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of the quantity of milk or of butter fat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Act and is not exempt. In other words, nonmember patrons must be treated the same as members in so far as the distribution of patron-

age dividends is concerned, that is, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Act that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The Act does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While under the Act patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association, instead of paying patronage dividends to nonmember producers in cash, keeps permanent records from which the proportionate shares of the patronage dividends due to nonmember producers can be determined, and such shares are made applicable toward the purchase price of a share of stock or of a membership in the association.

An association which has capital stock will not for such reason be denied exemption, (1) if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and (2) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership

of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends. The accumulation and maintenance of a reserve required by State statute, or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption. An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for nonmembers does not exceed the value of the products marketed for members. Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to partici-

pate in the management of the association, must be regarded as a member of such association within the meaning of section 101 (12).

(b) Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, live-stock growers, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. The term "supplies and equipment" as used in section 101 (12) includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household. The provisions of paragraph (a) relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph. An association which purchases supplies and equipment for nonmembers will not for such reason be denied exemption, provided the value of the purchases for nonmembers does not exceed the value of the supplies and equipment purchased for members, and provided the value of the purchases made for nonmembers who are not producers does not exceed 15 percent of the value of all its purchases.

(c) In order to be exempt under either (a) or (b) an association must establish that it has no net income for its own account other than that reflected in a reserve or surplus authorized in paragraph (a). An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Act. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under section 101 (12) and this article. An association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 101 (12).

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